



Key Steps

For Business Sale Preparation



Valuation | June 2021

Introduction

Many business owners plan to sell their businesses to fund retirement but find themselves unable to find a buyer. Several statistics highlight how prevalent this trend is. Business value accounts for approximately 80% to 90% of most owners' wealth.¹ In fact, 78% of owners expect to fund 80% or more of their retirement through the sale of their business.² However, only 20% to 30% of companies that are put on the market actually sell.³

These statistics indicate that many retiring people that are counting on the value of their business as part of their retirement plan are actually unable to convert that value into liquid assets. If liquidating business value is so important, why don't more companies sell? Most often, it is because people don't take the necessary steps to prepare their business for sale.

This discussion presents the steps that owners should consider if they plan to sell their business at some point. And it isn't just applicable to people imminently planning to sell. Many of these steps take years to implement even if one plans not to sell for ten years, the steps identified below are still applicable. Additionally, as some owners are often forced to sell their company due to circumstances outside of their control (e.g., death, disability, divorce, distress, or disagreement), it is good practice to maintain a saleable business in the event of an unplanned sale.

¹ Christopher M. Snider, "The State of Owner Readiness 2018 North Texas Report," Exit Planning Institute, 2018, p. 5.

² BizEquity, LLC, "About BizEquity," <https://www.bizequity.com/aboutbizequity> (accessed November 20, 2018).

³ Exit Planning Institute, "The State of Owner Readiness TM Research," <http://exitplanning-institute.org/state-of-owner-readiness/> (accessed November 20, 2018).

The sale preparation process can be broken down into three different stages

01.

Planning for the exit event

02.

Increasing business value in the time until the sale

03.

Preparations at the time of the sale

01.



Planning for the exit event

Many people wonder how far in advance they should begin preparing to sell their company. The answer is: the sooner the better.

A thorough due diligence process from potential buyers will include a review of five years' worth of financial statements, tax returns, and other information. Prospective buyers typically estimate value based on company performance over the past five years. Therefore, in order to increase salability owners should plan ahead to maintain an immaculate performance history.

The following sale preparation steps should be considered as far in advance as possible- ideally, at least three to five years before the planned sale.

Assess personal, financial, and business goals

Owners should first frame the planned liquidity even in the context of their personal, financial, and business goals. Personal goals may include family-oriented plans or ambitions around hobbies outside of work.

Financial goals relate to capital and liquidity requirements to fund one's lifestyle and plans. Business goals may include the legacy one wishes to leave behind in the community and any remaining items to be accomplished before the planned transition.

These goals are typically interdependent. Changes to goals in one category may affect the attainability of goals in another category. Owners should consider each of these areas to align their goals, estimate how much capital they need from the business exit, and decide when the right time to sell is.



Prepare reason for selling

“So why are you selling the company?” This question may be one of the first inquiries potential buyers make – and owners should be ready with a convincing answer. A buyer may be less likely to buy a company if the owner is selling it because they are “tired of dealing with all its difficulties” than if the owner is selling it “as part of an orderly transition to allow a new generation to take the firm in a new direction.”

Mental preparation for transition

Mental preparation is an important part of the sale preparation process. Owners often are personally attached to their business. Developing and managing a company takes a lot of time, commitment, patience, and sometimes luck. After all that hard work, relinquishing ownership can understandably be quite difficult. Many people also get a large part of their identity and standing in the community from this role, and giving up this responsibility may feel quite threatening on a personal level. Additionally, many owners feel responsible for the wellbeing of their employees. Transitioning this duty to a new party may feel uncomfortable.

In order to reduce some of these difficulties, owners should mentally prepare well in advance. This process looks different from person to person, but generally two components of the mental preparation process may be helpful: (1) identifying and addressing specific difficulties and (2) looking forward to the next steps rather than looking back at what one is leaving behind.

First, owners should determine what may cause them stress in the transition process. Specific actions may then be taken to reduce these stressors. For example, if one is concerned about employee wellbeing in the transition, one may seek acquirers with a reputation of treating employees well.

Second, shift ones focus from the good times left behind to the good times yet to come. Prepare a plan for the next life stages, including future career endeavors (if applicable) and/or new hobbies. Owners should have a clear idea of where they will spend their time and energy after they exit their company. These strategies help reduce the stress and anxiety associated with transitioning ownership. Not only will owners benefit mentally, but they may also benefit financially. By being mentally prepared for the transition, owners will be able to more fully commit their focus towards the energy-intensive process of selling their company.





Timing of sale

Economic conditions and position within the business cycle affect company value. If economic conditions are declining, it may be advantageous to delay the sale until conditions improve. Additionally, if the company has recently introduced a product line or expanded into new territory, it may be more advantageous to wait until operations have stabilized before selling the company. Buyers value stability.

As part of the contract of main business sales, the owner remains in some capacity to assist in the transition for several month or years following the date of the sale. This transition period is another factor to consider when deciding to sell.

Type of exit

At this point, owners may also begin identifying what type of buyer would be interested. Part of this process is to ask (1) who the next logical owner is and (2) who the next likely owner is. These may not be the same person. For example, the next logical owner in a family – owned business may be the son or daughter of the current owner.

However, the son or daughter may not be the next likely owner if they are not interested in owning it. Alternatively, the next logical owner may be a key competitor or a synergistic supplier, while the next likely buyer may be the son or daughter of the current owner.

This process may also entail exploring whether a strategic buyer or a financial buyer may be interested in the company. Strategic buyers are typically interested in generating a synergistic benefit through acquisition. Strategic buyers may include the competitors, suppliers, or customers. Financial buyers, on the other hand, generally are not involved in the subject company's industry and are only interested in buying the subject company for its financial performance. Strategic buyers can pay higher prices for companies than financial buyers. Owners should begin identifying potential buyers. Part of this process may also involve getting to know more about these potential acquirers, including learning their criteria for evolving prospects, identifying their key decision makes, and seeing how active they are in looking for opportunities.

Many profitable and effective exit strategies don't necessitate the sale of 100% of a company. Owners may also select other liquidity options such as a partial sales to a third party, selling a portion of the enterprise to management, a partial sale to an employee stock ownership plan (ESOP), or a dividend recapitalization program.



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Assemble a team of advisors

At this point, owners should begin putting together a team of advisors who specialize in business transitions. Members of this advisory team should include their lawyers, accountants, business valuation experts, and wealth managers. Other members may include exit planning specialists, investment bankers, and brokers.

Have a business valuation performed

Owners may also benefit from having a business valuation performed years in advance of the planned transition. A valuation will help in several ways. First, it will provide an approximate idea of future business value for planning purposes. Second, a thorough valuation will provide an analysis of the strengths and weaknesses of a company and how these factors affect business value. The owner will then have an enhanced perspective of which factors are negatively affecting value. This knowledge will help create a plan to increase value. Third, a valuation will help present the company from a third-party perspective. In one’s own house, one may overlook many flaws simply because one is used to them. Similarly, an owner may overlook the weakness in their business after years of working with them. A valuation provides a new perspective of how potential buyers may assess a company.



Increasing business value

After planning for the exit event, the next stage in the sale preparation process is increasing business value in the years leading up to the planned liquidity event.

The steps to increase value presented below relate to either (1) reducing risk, (2) increasing income, or (3) presenting evidence of value. Before examining each of these steps, the following gives a brief overview of how companies are typically valued.

Business valuation overview

These are three business valuation approaches: (1) the income approach, (2) the market approach, and (3) the asset-based approach. Within each valuation approach, there are multiple valuation methods. Valuation analysts may apply more than one method from more than one approach. The asset-based approach is less commonly applied in valuations for business sale purposes, so this discussion focuses only on the income and market approaches.

The income approach is premised on the assumption that the value of a company is a function of future income. In the income approach, valuation analysts discount projected future income to present value based on a rate of return that considers the risk of the business.

The market approach is grounded in a direct comparison of the subject entity to market transactions of similar companies. Pricing multiples are derived from transactions of interested in companies engaged in the same of similar lines of business. The multiple are then applied to the subject company's financial metrics to arrive at an indication of value. When selecting an appropriate multiple, valuation analysts consider how risky the subject company is relative to the guideline transactions of business interests.

Key takeaways to increase value

The previous descriptions are limited, but they contain the background information of how to increase business value. In both approaches, the key variables affecting value are income and risk. All else being equal, increasing income directly increases business value. However, risk inversely affects value. Risk and value are like two children playing on a seesaw: as risk goes up, value goes down, and as risk goes down, value goes up.

Accordingly, owners can increase the value of their company by increasing income or decreasing risk. Most of the sale preparation steps described below relate to one of these two factors.

Several of the factors below also relate to offering evidence of business value. This evidence of value reduced the need for the buyer to simply trust the word of the seller. Buying a company is a risky endeavor that often requires significant capital. With high stakes, data trumps unproven claims. By offering evidence of value, owners may increase the price that a potential buyer is willing to pay.





Implement business improvement projects

Preparing a business for sale is similar to putting a house on the market. When selling a house, one typically implements delayed home improvement projects. Similarly owners often also have business improvement projects that they will “get around to someday.”

Owners may benefit from carefully considering how they can clean up operations and maximize income in the years prior to the planned sale. Rather than waiting for the buyer to implement the “home improvement projects” to reduce expenses or increase revenue, owners should initiate the projects themselves. A listing may state “ABC Company generates income of \$5 million annually.”

A listing may state “ABC Company generates income of \$5 million annually. If one reduces expenses by cutting the number of staff and increases revenue by expanding into an identified new market, income will double. ” A listing of this form often bring up the following questions from potential buyers: If these opportunities are so lucrative, why hasn’t the current owner explored them already? What are the risks of these opportunities? Will making these changes actually improve the bottom line?

Many people get caught up in the daily grind of running a business. However, by carefully considering how to improve the company, the owner may be able to implement these changes and prove the value of these improvement projects to potential buyers.

Clean up

In addition to metaphorically cleaning up their businesses, people should literally clean up their businesses. Owners should tidy up all facilities and equipment to improve presentation to potential buyers.



Enhance business focus

Preparing a company for sale can also be similar to maintaining an orchard. Owners should prune operations to align with business focus and remove any areas that are not profitable. Throughout an enterprise's life cycle, managers often experiment with new product lines or service areas. This process is a healthy part of developing a business. However, the years prior to the sale of the company can be a poor time to experiment with the business model. Owners should instead eliminate underperforming segments and focus on core operations.

Part of this process may also entail selling or distributing nonoperating assets. Many businesses own assets not essential to operations. A potential buyer may not want these assets and may discount the value of these assets for liquidation costs. It may be more economical to liquidate these non-operating assets prior to listing the company for sale.

Document key processes and knowledge

Documentation of key processes and knowledge is essential for a new operator of a company with very little relevant industry experience. The years prior to the sale date are an excellent time to document this information to make the transition as easy as possible for the new owner.

Customer considerations

A comprehensive business valuation always considers the risk associated with the customer base. Factors that increase risk include customer concentration and nonrecurring revenue streams. Accordingly, company value may be increase by diversifying the customer base and putting key customers into long-term contracts.

While this concept can be succinctly summarized, it may be one of the more important ways to increase business value and salability.

Employee considerations

In most circumstances, it is judicious to limit employee knowledge of a potential business sale. A change in ownership is frequently accompanied by changes the negatively affect employees, such as reductions in headcount. Employees may also be uncomfortable with ensuing changes to the business model following an ownership change. Additionally, employees may be concerned with the viability of a company following the transition. Accordingly, if employees are aware that the business may soon be sold, they may seek more stable employment elsewhere. It may be best to therefore limit employee knowledge of a potential change in ownership.

Owners should also consider incentivizing key members of management to enter into long-term contracts. The success of many companies is directly tied to the performance of key members of management. Accordingly, owners should act to ensure that these employees remain through the transition. This step is particularly important because transitions may tend to trigger employees to seek employment elsewhere.



A background image showing a hand holding a document with a table. The table has columns for 'No. of fixed seats', 'Present value', 'Year of make', and 'Mileage'.

Maintain reliable financial statements

Business buyers take on considerable risk. Part of this risk is associated with trusting that the representations made by the seller are correct. One way to put buyers at ease is to maintain reliable financial statement prepared by an independent third party.

Accounting firms typically offer three levels of financial statement preparation:

1. Compiled
2. Reviewed
3. Audited

A minimum of three years of audited financial statements is desirable.

Many owners operate their business with the goal of reducing their tax expenses. They may funnel certain personal expenses through their company in order to reduce income taxes by decreasing pretax profit. However, by reducing profit, this strategy also reduces company value. Many business listings identify numerous “addbacks” to offset personal expenses funneled through the company. A potential buyer then has to trust the representations of the seller, who may have misrepresented income to taxing authorities. Demonstrated historical performance may offer more convincing evidence of value.

Reconsider keeping the business

After making all the preparations discussed previously, some people find that they keep the business rather than sell it. As mentioned before, selling outright is not the only option available to provide liquidity. At this point in the sale preparation process, owners should solidify their decision to sell the company. If selling is the selected route, owners should then consider the following steps in the months leading up to the planned liquidity event.

03.



Final preparations

As the planned liquidity of the event approaches, owners should begin preparing the documentation that a potential buyer would likely request. Sellers may avoid hiccups and delays in the selling process by preparing documentation of business value in advance. The selling price of a business may also be positively influenced by well-prepared documentation and presentation. The process of preparing documentation typically includes the following items.

Prepare a sales document

A sales document contains all of the information that a prospective buyer would need to get a high-level summary of a company. This document should include a qualitative description of the company and its operating environment including the following items:

- Summary of operations
- History
- Industry overview
- Competitive strengths
- Any factors that make the company special, different, or valuable, including any niches occupied



The sales document should also include a quantitative analysis summarizing the financial condition and operating performance of the company. A comprehensive, rigorous financial statement analysis typically includes the following elements:

- Income statements and balance sheets for the last five years or the most applicable time period based on the operating cycle and operating environment of the company
- Comparison to relevant industry benchmarks
- A ratio analysis including discussion of (1) liquidity, (2) coverage/leverage, (3) profitability, and (4) operations

The financial statement analysis should also include a narrative summarizing the financial condition of the company and highlighting its underlying financial drivers.

Create a forecast

As part of the sales document, owners should create a financial forecast to present to potential buyers. The forecast should be both realistic and supportable and should follow historical financial trends. If the forecast is unrealistically optimistic, it may jeopardize potential buyers' trust.



Prepare for due diligence

Buyers of businesses typically have extensive due diligence document request lists in order to understand as much about the company as possible. Commonly requested items include the following:

- Organizational documents (articles of incorporation, shareholder agreements, bylaws, etc.)
- Documentation of any prior sales of company ownership
- Historical financial statements
- Forecasts of budgets for future operations
- Upcoming capital expenditures
- Management organizational chart
- Employee turnover documentation
- Breakdown of sales and gross profit by product line or service
- List of top competitors and discussion of competitive advantages/disadvantages
- Discussion of customer concentration
- List of key suppliers
- Fixed asset listing
- Contingent liabilities (e.g., off-balance-sheet financing, environmental exposure, any active or pending lawsuits, etc.)

Revisit mental preparation

At this point, owners may also benefit from revisiting how mentally ready they are to sell. This isn't the time to second guess the decision. Rather it is a time to gather, resolve, and commit the time and energy to the actual sale process. This documentation, in conjunction with the steps discussed previously to increase value, should leave owners well prepared to not only liquidate business value but also to command a higher sale price.



Conclusion

Many people count on the value of their company to fund their retirement, but then find themselves unable to liquidate this value because of the difficulties selling their business. Many companies don't sell because the owners didn't take the necessary steps to prepare for the sale.

Owners should begin planning for the sale of their business years in advance of the anticipated liquidity event. In this time period, they should begin taking steps to increase business value by reducing risk, increasing cash flow, and preparing evidence of value. In the months before listing the company for sale, owners should assemble documentation of value for potential buyers.

The sale preparation process may take considerable time and energy. However, owners have already poured extensive resources into their business – preparing for sale is the final push in a marathon. The steps presented in this discussion may make the difference between being unable to sell a company and selling it at a lucrative price.

Business valuation is our forte

Our credentialed business valuation specialists bring clarity to the complexities of valuation while adhering to strict development and reporting standards. We thoroughly analyze the financial and operational performance of a company to understand the story behind the numbers.

For more information contact:



Casey Karlsen
Manager
ckarlsen@berrydunn.com



Seth Webber
Principal
swebber@berrydunn.com



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